Report on School District Reserves

California School Boards Association | December, 2014

With approval of Proposition 2, the school district reserve cap is now enacted as part of SB 858 (Chapter 32 of the Statutes of 2014), the education budget trailer bill.

This report shows how far reaching the reserve cap is and how it impacts funds that exist for legitimate purposes. It also dispels the myth that districts are hoarding money.

Executive Summary

It is well known that when the Legislature was three days away from adopting the 2014-15 state budget, Democratic budget leaders cited a request from the Governor for trailer bill language that limited the amount of school district reserves in those years following a year when the state makes a contribution to a new Proposition 98 reserve account, which was created in Proposition 2. Also included in that proposed language was a new requirement for annual justification by school districts of any amount of reserve levels in excess of the minimum reserve for economic uncertainty.

As part of these two new sections of the Education Code, the term "assigned and unassigned ending balances" is used to define the category of funds that districts are to be comparing to the required level of the minimum reserve for economic uncertainties and eventually spending down to. What is not clearly understood is what is meant by "assigned and unassigned ending balances," how much money that might be, and why districts have that money set aside in the first place. Findings in the report include:

Assigned and Unassigned Ending Balances Cover Numerous Areas of Specific Needs

Definitions for assigned and unassigned ending balances are provided by the Government Account Standards Board (GASB). According to that body, assigned ending balances are those funds set aside and intended to be used for a specific purpose. Unassigned ending balances are those funds set aside without a specific purpose and include reserves for economic uncertainty. This report shows that the universe of funds included in these definitions total nearly $17 billion statewide and include funds for such things as building fund reserves, bond interest redemption funds, self-insurance reserves, reserves for retiree benefits. The list goes on and totals 28 separate funds. Even if one was to argue that there is no possibility that anyone actually intended to include ALL assigned and unassigned ending balances and that they surely meant a more conservative definition such as only the General Fund and Special Reserve Fund for Other Than Capital Outlay Projects, that amount would total $7.9 billion statewide. (See Table 1)

Reserves for Economic Uncertainties

Statewide, minimum reserves for economic uncertainty total about $1.3 billion. Financial standards set those minimum amounts to between one and five percent of district funds, depending on size, with the largest district (Los Angeles USD) needing a minimum reserve of one percent and the state's smallest districts (up to 300 ADA) needing the higher amount between $50,000 and five percent of funds.

What the New Law Requires — Impact Increases Financial Risk

While districts have these ending balances set aside, the new law requires that they (1) annually justify those amounts that are above their minimum reserve for economic uncertainty and (2) spend down to twice the level of that minimum reserve when the state makes a contribution of any amount to the state-level Proposition 98 reserve account. While CSBA is supportive of the transparency part of the new law, it requires districts to justify ending balance amounts above the minimum level. Statewide, that means districts will be describing publically why they hold more than $1.3 billion in minimum reserves. This report shows that 896 school districts are above that minimum reserve amount thus necessitating that they disclose annually why they are holding those funds. Having to tell the public why a district is holding onto money needed to secure a good bond rating, or ensure adequate risk in a self-insurance fund, or meet the financial stress that is approaching from a lackluster economy will require more staff time during budget adoption season, and it appears that a good understanding for the public and for school boards will be a positive thing and show that the thought behind ending balances has nothing to do with hoarding money, and everything to do with sound fiscal planning.

But the shocking part of the new law is the requirement to spend down those reserves when there is a contribution at the state level of any amount to the state Proposition 98 reserve account. Using the broader definition of what could be included in the pot of money means that if even $1, or $500 million for that matter, is placed into the Proposition 98 reserve account, that action would result in school districts being forced into spending sprees to bring their balances to $2.6 billion (twice the level of their reserves for economic uncertainty). That spending spree could total between $5.3 billion and $14.4 billion depending on the definitions used. The impact on school district finances from raiding their ending balance ranges from exposing them to needing a bailout from the state, seeing their bond ratings go down and having to pay more interest when borrowing money for short and long term loans, not being able to meet financial obligations from retiree benefits, etc. Trying to stay solvent with such low reserve amounts while dodging apportionment deferrals, raising employee costs, guarding against years where there is no cost-of-living increase or, worse yet, actual funding reductions becomes a real problem.

Reserve Numbers are Skewed

One of the more interesting findings in the report is that while some cite that the statewide average for reserves is 30 percent, that number, while not really a surprise to those who are responsible for keeping school districts financially healthy, is skewed by the large number of small districts in California which by nature of their size need to have greater reserves than larger districts. Even the smallest change in financial circumstances is magnified in small districts. As a result, for the 40 percent of districts in the state with 1,000 or fewer children, the average ending balance level is 52 percent. Compare that to the 26 districts with 30,000 or more students where the average ending balance is 11 percent. For the 238 districts with 300 or less students, the average ending balance is 77 percent.

Conclusion: Reserves Serve Multiple Purposes

This report concludes that the trailer bill language (the cap and the transparency requirement) both appear to make a strong suggestion that the minimum required reserve for economic uncertainty is adequate or sufficient. But the paper demonstrates that there are numerous reasons that districts maintain ending balance reserves. The claim that some district ending balances are too high completely ignores the diversity among school districts in the state. It also ignores the work that school districts do to ensure fiscal stability, including planning and funding employee benefits and educational programs. By requiring districts to spend down their ending balances upon some unrelated trigger at the state level and to annually provide a "statement of reasons that substantiates the need" for reserves beyond the minimum puts enormous pressure on districts to unnecessarily spend down their reserves even if such action is financially risky.

Table 1. *Assigned and Unassigned Ending Balances (Dollars in Millions)*

Fund	Assigned Ending Balance	Unassigned Ending Balance	Reserve for Economic Uncertainty	Total
General Fund and Special Reserve Fund for other than Capital Outlay Project	2,811	3,168	1,923	7,902
Ending Balances for Funds Generally Not Considered As Part of a District's Reserve				
Building Fund	2,461	—	—	2,461
Bond Interest and Redemption Fund	1,223	—	—	1,223
Self-Insurance Fund	—	1,025	—	1,025
Capital Facilities Fund	968	(1)	—	967
Special Reserve Fund for Capital Outlay Projects	897	—	—	897
Capital Project Fund for Blended Component Units	454	—	—	454
Charter Schools Enterprise Fund	—	448	—	448
Special Reserve Fund for Postemployment Benefits	302	—	—	302
Deferred Maintenance Fund	252	—	—	252
Debt Service Fund for Blended Component Units	184	—	—	184
County School Facilities Fund	178	(1)	—	176
Retiree Benefit Fund	—	136	—	136
Charter Schools Special Revenue Fund	125	—	—	125
Adult Education Fund	85	—	—	85
Debt Service Fund	75	—	—	75
Other Funds[1]	72	49	—	120
Sub-Total	7,277	1,655	—	8,931
Total	**10,088**	**4,823**	**1,923**	**16,834**

1 Includes the following funds – other enterprise, child development, cafeteria special revenue, foundation private-purpose trust, pupil transportation equipment, forest reserve, foundation special revenue, foundation permanent, cafeteria enterprise, tax override, state school building lease-purchase, warehouse revolving, and special education pass-through.

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Introduction

In the 2014-15 budget trailer bill (SB 858 — Committee on Budget and Fiscal Review, Chapter 32 of the Statutes of 2014), the State enacted two new statutes relating to school district reserves: one to ensure transparency concerning reserve levels, and another that adds requirements that will limit school district's flexibility to maintain adequate fiscal reserves to ensure district solvency especially during state budget crises (Attachment 1 contains an excerpt of the relevant sections from SB 858.) Specifically, districts must:

- **Report and Justify Ending Balance Amounts.** Beginning with the adoption of their 2015-16 budgets, districts will be required to report and discuss at a public hearing any amounts of "assigned" and "unassigned" ending balances that are in excess of the minimum recommended reserve for economic uncertainty. In addition, the local board is required to adopt a statement of reasons that "substantiates" why the district is maintaining ending fund balances in excess of the minimum.

- **Establishes a Cap on Ending Fund Balances as Part of Proposition 98 Rainy Day Fund Created with Approval of Proposition 2.** Proposition 2 on the November 2014 ballot, established the Public School System Stabilization Account (PSSSA), which is commonly referred to as the Proposition 98 rainy day fund. Funding would flow into this account from higher-than-average capital gains revenues when specific fiscal criteria are met. In any fiscal year following a year in which funds flow into the PSSSA, districts would face a cap on the amount of assigned and unassigned ending fund balances that the district could maintain. Specifically, Los Angeles Unified School District would face a cap of three times its minimum reserve for economic uncertainty (three percent of total expenditures), and other districts would face a cap of two times their minimum reserves (the greater of $100,000 or between four percent and 10 percent of total expenditures depending upon attendance). County Offices of Education could grant limited term exemptions under certain circumstances.

This paper analyzes the potential impact on school district financial stability and fiscal planning that the limit on reserves could have. Unfortunately, both transparency and the cap requirements presuppose that the current statute that sets a minimum reserve for economic uncertainty is sufficient to protect a school district's fiscal solvency regardless of the state's fiscal situation, and that economic uncertainty is the only reason to maintain an ending balance. Under the narrowest of assumptions, SB 858's presumption about ending balances aligns with only a small handful of districts statewide. Almost all districts maintain ending balance reserves much larger than the minimum or the proposed cap. Interviews with district chief business officers (CBOs) identify numerous other reasons that districts maintain ending balances that are larger than the SB 858 cap. And when those other factors are combined with the uncertain fiscal environment that districts have faced through the great recession, it is understandable why districts have increased their ending balances to protect against the next fiscal crisis and meet other budgetary needs. And, while the current economic forecast appears to support steady growth in the short term, past experience demonstrates the volatility of California's revenues that results from a progressive tax system.

While neither SB 858 nor the Education Code specifically defines what an "assigned" or "unassigned" ending fund balance are, we assume for purpose of this analysis that these terms are consistent with the definitions made by the national Government Accounting Standards Board (GASB), which recently changed ending balance reporting requirements in order to improve transparency. Under these standards, unassigned ending fund balances are fairly clear in that they are funds set aside without specific purposes. It includes the reserve for economic uncertainty, although we will separate the two for parts of our analysis in order to identify the small size of the reserve for economic uncertainty compared to the assigned and other unassigned ending balances. Assigned ending fund balances are intended to be used for a specific purpose. If ending fund balances are intended for a specific purpose, and that purpose is approved by a local school board, then instead of being an assigned ending balance, the funds would be considered "committed." Since committed balances do not count against the proposed cap on ending balances, while assigned funds do, the distinction between the two will become quite important. See Attachment 2 for more details on ending balance reporting and recent improvements required by GASB.

Ending balances could be assigned to a myriad of purposes. Some examples of assigned ending balances from district level data include a fund balance that may be assigned to a project for which the general use of the funds are known, but not enough details have been worked out to have the local board commit the fund. For example, the ending balances could be assigned to a summer construction project, an instructional materials purchase, or a technology purchase. In other cases, the district might not know yet how much funds will be needed for a specific purpose. Examples of this type of assigned ending balance include an early retirement reserve, employee compensation negotiations or an audit reserve. Assigned ending balances may also be associated with carrying funds over from one year to the next for the same purpose as in the prior year.

Usually, discussions about district reserves focus on two funds in the State accounting system — the General Fund and the Special Reserve Fund for Other Than Capital Outlay Projects (unrestricted funds that districts have set aside for some purpose). However, the language in SB 858 does not specify that the ending balances only apply to the General Fund and the Special Reserve Fund for Other Than Capital Outlay Projects. In fact, the ending balance requirements appear to be general and would thus apply to all ending balances. Beyond the typical unrestricted fund ending balances analyzed when a district's "reserves" are discussed, these requirements would apply to ending balances for facility construction related funds, insurance funds, retirement related funds and numerous other smaller targeted funds. This analysis first assumes that the new requirements apply to all ending balances. It will then focus a more in-depth analysis on the ending balances for the two unrestricted funds to show the impact of this proposal even if the cap applies only to the General Fund and the Special Reserve Fund for Other Than Capital Outlay Projects.

Analysis of District's Current Ending-Balance Amounts Compared to Proposal

We analyzed data that districts report to the state through the Standardized Account Code Structure (SACS), which contains each district's accounting data reported at the end of a fiscal year. The most recent data available was from the 2012-13 budget. We use this data to analyze the impact that these policies would have on districts and the ending balances that they maintain. Because the data is available for each district, a district-by-district analysis can be conducted to identify not only the statewide impacts, but also disaggregated impacts for groups or even individual districts.

It should be noted that the requirements of SB 858 apply to the budget adoption process at the beginning of the fiscal year, whereas the SACS data analyzed below represents what actually happened during a fiscal year reported after the fiscal year is over. The district might assume that a fund balance will be spent during the fiscal year for a specific purpose, and it is only after the fiscal year that fund balances are assigned to a specific purpose. Thus, assigned ending balances reported in SACS might be higher than proposed assigned ending balances in the adopted district budget.

Statute Appears to Include All Ending Fund Balances Not Just the Unrestricted Funds

If we assume that the requirements of SB 858 apply to all district funds, then there is a nonsensical disconnect in the policy. First, the policy would require districts to substantiate any assigned or unassigned ending balance for most of their funds. Statewide, the required reserves for economic uncertainty (discussed in detail below) is around $1.3 billion. Table 1 shows that districts currently have $16.8 billion in assigned and unassigned ending balances, roughly 13 times the reserves for economic uncertainty. So, beginning with the budget adopted for the 2015-16 fiscal year, districts will need to "substantiate" maintaining $15.5 billion of ending balances that are beyond that limit.

With passage of Proposition 2, then in the future districts could be capped at double or triple their minimum reserve for economic uncertainty. This cap totals $2.6 billion statewide (using 2012-13 data to measure the impact), just over double the reserves for economic uncertainty (because Los Angeles Unified School District would be capped at triple). Using current numbers if the cap were imposed, districts would need to reduce assigned and unassigned ending balances by $14.3 billion. Since the minimum reserve for economic uncertainty must still be maintained — $1.3 billion — that leaves only $1.3 billion in ending balances for all of the other purposes. Not even the current building fund could be maintained for many districts.

Clearly the current language in SB 858 appears to be deeply flawed. It would basically force districts to get rid of almost all of their ending balances even for funds for which ending balances make a lot of sense such as for insurance funds, capital funds and retirement related funds. For example, some districts are large enough or pool their resources with other districts to self-insure for property, crime, equipment, liability and other purposes. Self-insuring can save districts a lot of money over time. But, in their budgets, these self-insurance funds show up as unassigned ending balances. The SB 858 cap would force districts to stop self-insuring because the self-insurance funds would push those districts over their caps. Instead, districts would pay insurance companies premiums which would be an ongoing operational expense, and would cost the districts more. Not surprisingly, the largest districts tend to self-insure. For example, the Los Angeles Unified School District maintained a $334 million ending balance in its Self-Insurance Fund in 2012-13, almost double the district's proposed cap on ending balances.

For some capital projects, districts do not commit funding to a specific project until all of the details are finalized; until, for example, all permits have been issued. Instead, the district assigns funds to the project while all of the details are being finalized. But, in this period after a project has been identified and the details have been finalized, often a district will set aside funds in the Building Fund for that project, or "assign" funds for the project. This again would not be permitted under the SB 858 ending balance cap because the ending balance in the Building Fund could count against that cap. For example, William Hart Union High School District had an assigned ending balance of $175 million at the end of 2012-13 in its Building Fund. The district's ending balance cap would only be just over $10 million, thus precluding such an ending balance for its Building Fund.

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Because the attempt for a 2014 state school bond failed and the interest of the Administration to reduce the State's role in the financing of school buildings, it is likely that more and more districts will be relying on local financing of their capital outlay projects. As such, the ending balances that districts will need to carry in their facility related funds is likely to increase in the near future instead of decline.

As shown in Table 1, most of the other funds with assigned or unassigned ending balances are either for other capital-related funds or for employee retirement related funds.

Table 2 summarizes the 2012-13 ending balances for districts for all funds. The maximum ending balance under SB 858 would vary by the size of the district from three percent of total expenditures for the largest district to 10 percent of total expenditures (or $100,000) for the smallest. For each size group of districts, the table shows the average 2012-13 ending balance disaggregated into the portion of the ending balances that are generally unrestricted — General Fund and Special Reserve for Other Than Capital Outlay — and the more restricted funds. When these two categories of ending balances are combined, the average district in each of these size groups varies from 24 percent for the largest district to 97 percent for the smallest districts.

In years when SB 858 is operative, the statute would effectively require districts to maintain their ending balances in a narrow window between the minimum reserve for economic uncertainty and the SB 858 cap. For 2012-13, there were only 14 districts in the state operating in this window, less than 2 percent of all districts. Thus, 934 districts (98 percent) would be required to reduce their ending balances under the proposal, and most districts would have to reduce their ending balances significantly.

Table 2. *Ending Balances for All Funds Exceed Proposed Cap for Most Districts (2012-13)*

District size	0 — 300	301 — 1K	1K — 30K	30K — 400K	400K +	
Max ending balance proposed	$100K or 10%	8%	6%	4%	3%	
Average gf / special reserve (non-capital) ending balance %	77%	35%	21%	11%	9%	
Average other fund ending balance %	20%	16%	19%	19%	15%	
Total average ending balance %	97%	51%	40%	30%	24%	**Total**
Number of districts ending balance below min reserve	0	0	1	0	0	**1**
Number of districts in between min and max	3	3	8	0	0	**14**
Number of districts exceed ending balance max	235	166	507	25	1	**934**

Not only do almost all districts exceed the proposed ending balance cap, most districts exceed their caps by a lot. Table 3 shows that 84 percent of districts have assigned and unassigned ending balances that are three times their proposed caps, and over half of districts' ending balances are five times the proposed cap.

Table 3. *Percent of Districts that Exceed Ending Balance Cap and Other Thresholds*

Ending Balance Level	Percent of Districts
Exceeds Proposed Cap	98%
Exceeds Double Cap	93%
Exceeds Triple Cap	84%
Exceeds Five Times Cap	58%

Because of the consequences that a true reading of the statue would have, it brings into question the motives of the proponents. Because including the broader universe of assigned and unassigned ending balances is absurd, proponents may have intended that these requirements only apply to the unrestricted funds including the General Fund and the Special Reserve Fund for Other Than Capital Outlay Projects. The remainder of this analysis focuses on these two unrestricted funds to show that even if this narrow interpretation was the intent, there would still be significant damage to the fiscal health of districts from the reserve cap.

Apply Concept to Only General Fund Ending Balances Would Still Force Districts to Substantially Reduce Ending Balances

Focusing the analysis just on the General Fund and Special Reserve Fund for Other Than Capital Outlay Projects (for purposes of simplicity, the remainder of the report will refer to these combined funds as General Fund because the two funds share similar characteristics in their unrestricted uses). Table 4 shows that these assigned and unassigned ending balances total $7.9 billion. Again the district-by-district analysis of minimum reserves for economic uncertainty is $1.3 billion statewide. Thus, districts have reported higher reserves for economic uncertainty than required, and when combined with assigned and unassigned ending fund balances, the current ending balances exceed the minimum amount by $6.6 billion. So, if the policy only applied to these funds, district boards would still have to substantiate $6.6 billion in ending balances.

Table 4. *Districts' General Fund Assigned and Unassigned Ending Fund Balances (Dollars in Millions)*

Ending Fund Balances	Amount
Assigned Fund Balances	2,811
Unassigned Fund Balances	3,168
Reserve for Economic Uncertainty	1,923
Total	**7,902**

In relationship to the proposed caps, the current ending balances exceed the proposed caps by $5.3 billion meaning that combined districts would need to reduce their ending balances by this amount to meet the new requirements.

The minimum reserves for economic uncertainty and the proposed maximum ending fund balance vary by district size. The smallest districts must maintain reserves for economic uncertainty of the greater of five percent of total expenditures or $50,000 in reserves. The percent of a district's expenditures that are required as a minimum reserve decreases as the size of a district increases. The first column of Table 5 shows the amount of minimum reserves for economic uncertainty that a district must maintain by size groups. And the second column shows the maximum cap on ending balances that SB 858 imposes. It turns out that this is a very narrow window for reserves and ending balances in which few districts currently operate.

Table 5 shows how districts' 2012-13 ending balances compare to these ranges. Currently only 7 districts have ending balances below the minimum required amount (we will discuss these districts below). There are 46 districts between the minimum reserve and the proposed maximum ending fund balance. However, 896 districts (94% of districts) currently have ending balance levels in excess of the proposed ending balance caps. If these caps were operative, 896 districts would have to reduce their ending balances to be compliant with SB 858, and without regard to the impact that might have on future borrowing costs, the ability to meet future financial obligations, or plan for future expenditures.

Table 5 also shows the average ending balance for the different sized districts. In fact, the average ending fund balance in 2012-13 ranges from nine percent to 77 percent depending upon size groups. Generally, the average ending balance is around three times or more the proposed maximum amount. For example, the largest group of districts, those with between 1,000 average daily attendance (ADA) and 30,000 have an average ending balance of 21 percent, three and-a-half times the proposed maximum ending balance of six percent. For the larger districts in the state (30,000 to 400,000 ADA), only one district is in the proposed range with the remaining 24 districts above the proposed range. On average these districts have an ending fund balance of 11 percent, instead of the maximum four percent proposed. But overall statewide averages are skewed toward higher average numbers because small districts are so far above larger districts in the size of their ending balances. For example, some 40 percent of school districts in the state are under 1,000 ADA and that group of districts has an average ending balance of 52 percent compared to an average ending balance of 11 percent for the 25 districts between 30,000 and 400,000 ADA.

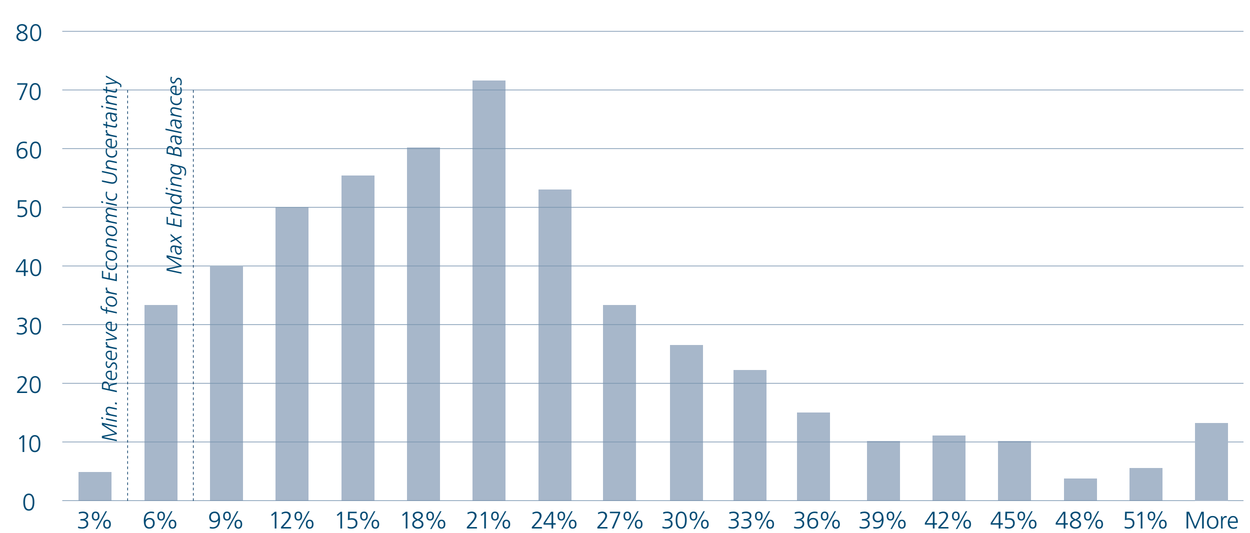
2 Also includes any Special Reserve Fund for Other than Capital Outlay Projects that districts may have created to maintain ending fund balances that are generally unrestricted in nature.

Table 5. *Most Districts General Fund*[3] *Ending Balances Exceeded Proposed Maximum in 2012-13*

District Size	Min Reserve for Economic Uncertainty	Max Ending Balance Proposed	Average Ending Balance %	Districts Below Min Reserve	Districts Between Min and Max	Districts Exceeding Ending Balance Max	Total Districts
0 — 300	$50K or 5%	$100K or 10%	77%	0	4	234	238
301 — 1K	4%	8%	35%	3	8	158	169
1K — 30K	3%	6%	21%	4	33	479	516
30K — 400K	2%	4%	11%	0	1	24	25
400K +	1%	3%	9%	0	0	1	1
			Total	**7**	**46**	**896**	**949**

Looking at the 1,000 ADA to 30,000 ADA range districts more closely, Figure 1 displays the distribution of ending fund balance percentages of total expenditures. The red bars represent the current minimum reserve and proposed maximum ending balance, and shows that 33 districts had ending balances in this range in 2012-13. Most of these medium-sized districts had ending balances that were two times to four times the proposed maximum ending balance percentages. The medium sized district with the highest ending balance was 93 percent of their total expenditures.

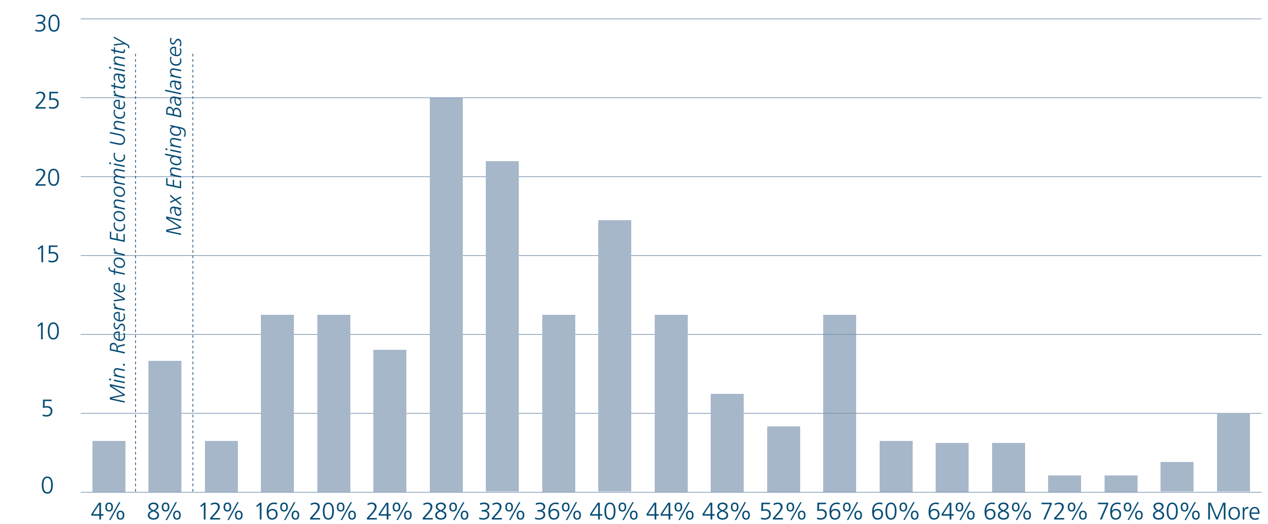
Figure 1. *2012-13 Ending Balances Percentage for Medium Sized Districts (1,000 to 30,000 ADA)*



3 Includes ending balances from the Special Reserve Fund for Other than Capital Outlay Projects.

Figure 2 shows the ending fund balances as a percent of total expenditures for smaller districts (300 to 1,000 ADA). Only eight districts have between four percent and eight percent ending balances. As you can see, these districts have an even wider distribution, with some districts maintaining assigned and unassigned ending fund balances as much as 10 times the proposed ending balance cap of eight percent. The distribution of the smallest districts (less than 300 students) is even larger than for these small districts.

Figure 2. *2012-13 Ending Fund Balances for Sm. Districts (300 — 1,000 ADA)*



Context for Current Ending Balances

Because the data analyzed above shows that the ending balances of almost all districts are above both the minimum and the proposed caps, it is worth investigating some of the reasons that districts may be maintaining reserves larger than these proposed caps. The first reason has to do with the recent unprecedented fiscal uncertainties that all districts in the state faced. The Great Recession has caused a difficult fiscal environment that generally all districts experienced. During the recession, districts endured mid-year cuts and threats of mid-year cuts, no cost-of-living increases, growing deferrals, declining property tax revenues, declining enrollment for half of the districts and increasing apportionment deferrals. At certain points in any given fiscal year, school districts were operating on 60 cents on the dollar of what was called for in statute.

At the same time, in addition to the overall fiscal environment, individual districts face unique fiscal pressures that vary across districts, and help explain the huge variation in ending balances across districts. Because districts are unique, the state has developed a complex process for reviewing the fiscal health of districts. And while ending balances is one factor that is taken into account, it is only one among many. Below we illustrate the disconnect between the state process for reviewing district fiscal health, commonly referred to as the AB 1200 (Chapter 1213, of the Statutes of 1991) process, and the proposed ending balance cap.

Districts Grow Ending Balances in Response to State's Unprecedented Fiscal Uncertainties

Consistent with good practice, districts have increased their ending fund balances in periods of greater fiscal uncertainties. Recent fiscal events at the State level have resulted in the expected response by districts to increase their ending balances as fiscal uncertainty increased. Through the Proposition 98 minimum guarantee calculation, school funding is directly linked to the fate of the state General Fund. Thus, when the State has faced fiscal challenges, especially those caused by the Great Recession, districts generally increased their reserves to protect against the increased fiscal uncertainty.

Starting with the dot-com bubble bursting in 2001, the state has spent most of the last 13 years with an ongoing structural budget gap that caused greater fiscal uncertainty for school districts. And, while the last couple of budgets have finally addressed this structural budget challenge, a large part of that solution came on the backs of school districts in the form of significant budget cuts and suspension and manipulation of the Proposition 98 minimum funding guarantee. The State is still in the process of repaying debts that were accumulated over this time period. When the Great Recession hit California starting in 2008-09, the State created an unprecedented environment of fiscal uncertainty for school districts. As would be expected, districts reacted to this uncertainty by increasing their ending balance reserves to ensure fiscal solvency not knowing when California would hit the bottom of the recession and start recovering. While this increased uncertainty perhaps should have led to the State requiring larger minimum reserves for economic uncertainty to ensure that districts could weather the storm, the State actually temporarily suspended the minimum reserves. Fortunately, districts acted on their own to protect their fiscal solvency by increasing reserve levels instead of reducing them. Table 6 shows data on ending balance reserves reported by School Services of California over the last several years.[4]

Table 6. *Average Ending Balances as Percent of Total Expenditures*

	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Unified Districts	8.3%	11.1%	11.2%	15.3%	15.4%	14.8%
Elementary School Districts	14.0%	17.8%	18.9%	23.2%	23.8%	23.0%
High School Districts	11.5%	15.1%	17.5%	20.4%	19.8%	19.3%

Given the fiscal uncertainty for districts during this time period, it is not surprising that districts have protected themselves from the uncertainty by increasing their reserves. Some districts have concern that the recent uncertainty might be a new normal because during this time period, the State on several occasions undermined the historic operations of the Proposition 98 minimum guarantee as well as suspending that guarantee. And, for reasons described below, we would not expect ending balances to begin to fall significantly until the 2014-15 fiscal year.

4 Special thanks to School Services of California for providing data on ending balances going back to 2007-08. These numbers only include ending balances for the General Fund and Special Reserve Fund for Other Than Capital Outlay Projects similar to the narrow definition described in Attachment 2.

Table 7 highlights some of the major fiscal events that districts have faced over the last seven years that have forced districts to be prepared for greater fiscal uncertainty. These events include: Proposition 98 suspension, major budget cuts, threats of cuts, mid-year cuts, trigger cuts, $9.5 billion in funding deferrals, a new funding model and significantly increased teacher retirement costs. Each state action or fiscal event in Table 5 through the passage of Proposition 30 further deteriorated the fiscal confidence that districts had in the state. And that confidence is only now recovering.

Table 7. *Major Fiscal Events Creating Climate of Fiscal Uncertainty for School Districts*

2008-09: Great Recession Starts. Ongoing state funding for schools replaced with one-time stop gap measures that partially backfilled these cuts over the 2008-09 and 2009-10 budget years including federal stimulus funds ($4.8 billion), increased funding deferrals ($4.6 billion) and flexibility to transfer restricted reserves to unrestricted reserves (estimated $2.2 billion). The increased deferrals were on top of funding deferrals that started in 2001-02, and continued to grow. In addition, statutory COLAs were suspended, a trend that continued until the 2013-14 budget.
2009-10: Deferrals, Budget Special Sessions, and Mid-Year Cut. Continued reliance on one-time funding, although most of these funds exhausted by end of year. State reaches highest level of K-12 funding deferrals at $9.5 billion annually, virtually exhausting this budget option as an alternative to budget reductions. 2009-10 also included two special sessions to further deal with the ongoing budget shortfall, resulting in mid-year cuts to schools.
2010-11: Proposition 98 Suspension. The latest state budget in state history (Oct 7th) forces districts to operate for over 3 months without a state budget. Budget suspends the Proposition 98 guarantee, reducing school funding over $4 billion.
2011-12: Proposition 98 Manipulations and Mid-Year Trigger Cuts. Budget Act balanced budget by assuming higher than projected General Fund revenues and proposed $1.8 billion in K-12 education trigger cuts if higher-than-expected revenues did not materialize. A portion of the trigger cuts happened although the specifics of the reductions changed over the course of the year, changing the distribution of the cuts across districts. Budget also relied on manipulations of Proposition 98 guarantee by designating General Fund revenues for realignment, thereby excluding those revenues from the minimum guarantee calculation (resulted in $2.1 billion reduction in K-14 funding).
2012-13: $5.4 Billion in Trigger Cuts if Proposition 30 Failed. State adopts budget that included $5.4 billion in trigger cuts for K-14 education if Proposition 30 did not pass. Fiscally conservative districts assumed that Prop 30 would fail in adopting their 2012-13 budgets because they would be unable to dramatically change their staffing decisions if the initiative failed over four months into the fiscal year. This proposal included further manipulations of the Proposition 98 minimum guarantee if trigger cuts were implemented to achieve this level of reduction without suspending the minimum guarantee.
2013-14: Local Control Funding Formula (LCFF) Changes Funding Distribution. State adopts the LCFF in June 2013 dramatically changing the distribution of resources across districts. Fiscal regulations governing these new dollars not available until January 2014. Actual apportionment amounts are not known until June 2014 in the last month of the budget year. Districts with fewer unduplicated pupils (low income students, English learners or foster youth) will see much slower revenue growth for many years.
2014-15: Continual CalSTRS and CalPERS Increases Scheduled over Next Seven Years. While 2014-15 brought a large infusion of new funding and the retirement of deferrals, the State also committed school districts to increased and growing California State Teachers' Retirement System (CalSTRS) contributions rates for the next seven years. District costs will increase $3.7 billion over the next seven years. Districts will face these higher costs regardless of whether the annual budget provides enough new resources to cover those costs. Similarly, the California Public Employees' Retirement System (CalPERS) board made changes in its actuarial assumptions (reducing expected rate of return and increasing life expectancy) that will cause PERS rates to increase for the next seven years as well.

Source: LAO various Annual Spending Plans.

Given all of the budgetary challenges districts have faced over this time period, it is surprising that more districts did not end up needing the state to intervene with emergency loans (two districts needed state emergency loans during this time period: South Monterey County Joint Union High School District and Inglewood Unified School District). In part, districts' abilities to maintain solvency during this challenging budgetary time period is related to the fact that districts were able to maintain significant reserves, but also because of the success of the AB 1200 process for reviewing district budgets using multiple measures as discussed below.

With the passage of Proposition 30 and a continuing recovery of the state's economy, most school districts' budgets are in much better shape and have begun to restore some of the most harmful budget reductions that have been made. At the same time, there are still significant uncertainties in the near future. Proposition 30 has increased the reliance of state revenues on high-income earners including capital gains revenues. And, while these revenues have been increasing at a rapid pace, we know from past experience that they can fall off just as quickly. In addition, Proposition 30 is only a temporary revenue source, and given that it phases out over a multi-year period starting in 2016, it would take the state having its longest economic expansion in modern history to not have another economic downturn either before or during the Proposition 30 phase out. These combined impacts could quickly put districts in a challenging fiscal situation in which significant fiscal reserves are needed.

We have not been able to find research supporting that the current required minimum reserves for economic uncertainty would be sufficient to actually address the economic uncertainty in the state, nor research to justify the original political determination of the current minimum reserves. And, currently, there is not a process to review the minimum reserve level to reflect any changes in economic circumstances such as the increase dependency of state General Fund revenues on volatile high income earners.

Districts Have Numerous Reasons for Maintaining Ending Balances Beyond Minimum Reserve for Economic Uncertainties

While all districts have been impacted by the poor state economy and uncertainty since 2007-08 heightening the desire of all districts to increase their reserves, other factors impacting desired district reserve levels vary significantly by district. There are numerous other factors that vary across districts that impact appropriate levels of reserves. For the same reasons that local decision making is important in budgeting and planning as required under the new Local Control Funding Formula (LCFF), local decision making is critical for determining appropriate ending balance reserves not only to cover future uncertainties, but for some planned expenditures as well. The minimum reserves for economic uncertainty vary by the size of the district ranging from one percent to five percent of a district's funding or $50,000 for the smallest districts in the state. So, size is at least somewhat taken into consideration, but may not totally cover the financial challenges that small districts face. In addition to size, other factors that impact a district's ending balance needs include:

- **Cash Flow Needs, Especially for Districts Highly Dependent on Local Property Taxes Like Basic Aid Districts.** Revenues coming to districts from state and local property tax revenues do not always match when districts face payroll and other expenses. For example, local property tax revenues are only provided to districts twice a year, in December and April. So especially for districts that rely mainly, or solely, on local property tax revenues, even if the district has enough revenue over the course of the year to cover all of its expenses, it might run out of cash especially in the summer and fall months when little to no revenue is coming in, but the district still has payroll and other expenses. For example, basic aid districts receive almost no state aid, and thus most of their funding comes from these two tax payments a year. Districts have two choices to meet these cash flow needs: borrow the funding and pay interest on funds or carry substantial enough reserves to cover the cash flow needs. Statute recognizes district needs to maintain reserves for cash flow purposes. Specifically, Education Code Section 42124.

  The budget may also contain an amount to be known as the general reserve in such sum as the governing board may deem sufficient, for the next succeeding fiscal year, to meet the cash requirements to which the district's credit may be legally extended for that portion of said next succeeding fiscal year until adequate proceeds of the taxes levied for, or apportionment of state funds made to, the district during such succeeding fiscal year are available to the district.

  However, the SB 858 ending balance cap would seem to ignore this section of code because districts would need to limit their holdings of reserves for cash flow purposes.

- **Declining Enrollment.** Declining enrollment is an ongoing budget challenge for half the districts in the state. Expenses do not decline at the same rate that revenues decline; thus, for districts that are shrinking they will face out-year budgets with greater declines in revenues than expenditures. Therefore, a district would maintain a higher ending balance to prepare for the inevitable. Also, if a district has uncertainty about its future enrollment as a result of local land development decisions, then the need for greater ending balances would increase.

- **Collective Bargaining and Salary Commitments.** Often, districts maintain ending fund balances knowing that the district will be negotiating with their employee unions after a budget has been adopted, and will need at least some of those fund balances in order to meet growing salary and benefit costs that will result from the collective bargaining process. Because the negotiations have not been completed, the district does not know exactly how much will be needed for these costs, so it doesn't want to commit to a specific amount in its budget.

  In addition, district salary costs can rise even when the salary schedule remains the same from year-to-year. Every year certificated and classified salaries increase based on years of experience and education levels (step and column increases). Because the state requires districts to submit three-year budget projections (discussed in detail below), the district may need to set funding aside to cover the increased costs of salaries that it expects in the near future. These costs often occur at the same time that state funding for schools slow because average educator experience tends to increase during recessions (fewer new hires at the bottom of the pay scales and fewer retirements at the top end of the scales).

- **Increasing CalSTRS and CalPERS Employers Contribution Rates.** As part of the 2014-15 budget, a last minute proposal by the Governor led to a deal (AB 1469, Bonta, Chapter 47 of the Statutes of 2014) that will increase districts' CalSTRS contributions by from 8.25 percent of certificated payroll to 19.1 percent by 2020-21. This is a 232 percent increase in CalSTRS costs over this time period. The LAO estimates that the additional costs for districts will grow annually for the next seven years and that by 2020-21, districts will be paying an additional $3.7 billion annually. These cost increases will happen regardless of whether the state increases Proposition 98 funding for schools during this time period. Similarly, the State changed its underlying assumptions for CalPERS, decreasing the average expected rate of return on investments, and increase the average lifespan of retirees. As a result in Spring 2014, the CalPERS board projected that employer rates will increase from 11.44 percent of classified payroll to 20.4 percent by 2020-21, an increase of 178 percent over this seven year period.

- **Other Post-Employment Benefits (OPEBs) — Retiree Health Care Costs.** As part of total compensation, many districts have provided benefit to their retirees. The largest of these OPEBs is health benefits for retirees. Unlike pensions for which districts, employees and the State set aside resources each year to cover these future costs, most districts have not set aside funds for these retiree health benefits, and must pay for them out of operating funds. As more teachers retire and health care costs increase, these fiscal obligations can grow quickly. GASB has proposed stricter liability reporting requirements that are currently under review. If approved, the new rule could require districts to address these obligations sooner, increasing the near term costs for districts. Again, if districts can't count on future state funding increases to cover these costs, they must carry adequate ending balance reserves to ensure that they can meet these future obligations.

- **Facility Maintenance and Deferred Maintenance.** The State reduced the amount that districts were required to provide from their unrestricted funds for annual maintenance and deferred maintenance during the Great Recession to provide fiscal relief. Many districts took advantage of this flexibility and reduced their maintenance spending. As a result, many districts have large facility-related needs that have been deferred and will need to be met in the near future. Carrying larger reserves ensures that the funds are available if any of these maintenance needs become critical or take several years of funding to address. Districts could formally commit such funding for specific maintenance projects, but then they would lose the flexibility to repurpose those funds if a future budget crisis occurs.

- **Instructional Materials and Technology Needs.** Districts might be carrying extra reserves knowing that they will be making major purchases of instructional materials over the next several years as materials become available for Common Core in math and English language arts and Next Generation Science Standards. Statewide, these materials will cost billions of dollars, far in excess of the resources that the State has directly allocated for this purpose. Districts may be hoping that the State will appropriate additional funding to meet these needs in future budgets, but are maintaining reserves in case that does not happen. Similarly, many districts have delayed technology upgrades and computer replacements, and must make these investments in the near future to ensure that they are prepared for administering the new state assessments.

- **Common Core State Standards.** Similar to the previous issue, school districts are currently implementing Common Core State Standards (CCSS). A recent survey by the CA Department of Education estimated conservatively that start-up costs would equal about $500 per student for instructional materials, technology and professional development. So far, the state budget has committed $200 per student in one-time monies in 2013-14, and stated in the 2014-15 budget that some payments for mandate claims can also be used for CCSS. Some districts may need to use their reserves for common core implementation costs to bring their human and programmatic infrastructure up to speed in order to ensure student and teacher success with the new standards. There is uncertainty as to whether the State will provide additional funding, and there were discussions in the 2014-15 budget process on the issue. Thus, some districts may be building up reserves to meet these higher costs, while waiting and hoping that the state will takes actions to address these additional costs of the state policy.

Cap on Ending Balances Conflicts with State Fiscal Oversight System (AB 1200)

Because local budgetary fiscal factors vary across districts, the State has developed a complex review process, the AB 1200 review process, that takes these varying factors into account. The proposed ending balance cap would conflict with AB 1200, under which districts must submit their budgets and revised budgets to county offices of education (COEs) for review. When a district submits its budget, the COE looks at 10 criteria and up to 10 sets of supplemental information to determine if a district can meet its current fiscal obligations for the next three years. (See Attachment 3 for specific details on the criteria and standards used in the process.) These criteria incorporate many of the factors that lead districts to maintain larger ending balance reserves as discussed above.

If a district or COE believes that a district cannot make its budget-year commitments without corrective actions, the district is given a negative certification, and those whose three-year commitments are questionable is given a qualified certification. Basically for these districts some actions are necessary or the district will not be able to make payroll in the next year or may not be able to over the next three years.

Not surprisingly, the Fiscal Crisis Management and Assistance Team (FCMAT) has found that maintaining adequate reserves is one of the most important conditions that have been found to frequently indicate fiscal distress. If a district is struggling in other areas that district will likely need a larger fiscal reserve to balance the solvency risks. In addition to ending balance amounts projected for the next three years and not just the budget year, the process looks at three years of projections for enrollment/attendance trends, salary commitments, revenue projections, facility needs, deficit spending, and other factors. This process has been quite successful, limiting the number of districts needing emergency loans to only five districts over the last 20 years.

The ending balance cap would completely undermine the AB 1200 process. Instead of looking at all of these factors in concert with one another to get an overall view of a district's financial situation, the state would constrain districts' abilities to offset all of these risks and cost pressures with increased reserve levels. In addition, the cap only focuses on a one-year time horizon instead of looking at a longer three-year fiscal assessment. With the implementation of LCFF, the state has pushed for districts to lengthen their planning horizon (three-year LCAP process) to align with their three-year budgeting process. Instead, this ending balance cap would undermine those processes effectively returning districts to only plan one year at a time.

Most Negative and Qualified Districts' Ending Balances Exceed Proposed Cap

Under AB 1200, COEs identify districts that are fiscally at risk — negative certification (cannot meet budget obligations without corrective action) or qualified certification (may not meet budget obligations in subsequent two years). Taking a close look at the ending balance data for the districts that were either negative or qualified for 2012-13 further identifies the disconnect between the ending balance caps and the broader fiscal health of districts. One might assume that all of these districts would have low ending fund balances and would not be impacted by this new law. But, that is not the case. In fact, even most of these fiscally-distressed districts would need to further reduce their ending balances.

Table 8 shows the ending balances for districts with a negative certification in 2012-13. According to their COEs, these districts will need to take corrective actions in the budget year in order to meet the districts' current obligations. If these districts have any ending fund balances above the minimum, the districts would need to use all of those reserves and more in order to meet its obligations for the year. As you would expect, the ending fund balance for these districts is less than the state average levels. However, if the reserve cap was in place in 2012-13, six of the eight districts with a negative certification would be told that their ending balances were too high, and should be further reduced. This of course would make the fiscal struggles of these districts even worse.

The AB 1200 process looks at multiple measures, and not just the ending balances. Thus for these districts, even having ending balances in excess of the caps were not enough to overcome the other fiscal challenges that the districts face. Forcing such districts to further reduce their ending balances would be fiscally irresponsible, although the reserve cap contained in SB 858 would require just that.

Table 8. *Ending Balances for Districts Negatively Certified in 2012-13*

District	ADA	Minimum Reserve for Economic Uncertainty	Ending Balance Percent	Exceeds 2x Minimum
Denair Unified	930	4%	-4%	No
Wilsona Elementary	1,316	3%	13%	Yes
South Monterey Co Jt Union High	1,831	3%	7%	Yes
Windsor Unified	4,865	3%	8%	Yes
San Ysidro Elementary	4,921	3%	7%	Yes
Victor Valley Union High	9,338	3%	7%	Yes
Upland Unified	11,417	3%	5%	No
Inglewood Unified	11,703	3%	16%	Yes
Average			7%	

Table 9 looks at the ending balances of the qualified districts (at fiscal risk in the next three years absent corrective action). Of the 84 qualified districts, 72 districts have ending balances in excess of the proposed cap. For the medium sized districts (1,000 to 30,000) the average ending balance is 13 percent of total expenditures, over double the proposed cap. Again for these districts, their current ending balances might be inadequate to protect the district from fiscal crisis over the next three years, yet these districts would have to further reduce their ending balances.

Table 9. *Most Qualified Districts Exceed Proposed Ending-Balance Cap*

District size	Average ending balance %	Districts below reserve min	Districts in between min and max	Districts exceed ending balance max
0 - 300	37%	0	0	5
301 — 1K	24%	1	1	8
1K — 30K	13%	1	8	52
30K — 400K	7%	0	1	6
400K +	9%	0	0	1
	Total	2	10	72

We conclude that at least for some districts in the state, the maximum ending balances would put the district in fiscal peril. If all of the other criteria used in the AB 1200 process are sending the district's finances in the right direction (state finances strong, attendance predictably growing, salaries and benefits are growing slowly, facilities in good repair, no growth in pension obligations…), limiting ending balances would still be a move in the opposite direction.

District Bond Ratings are Dependent on Ending Balance Reserves — Reduced Reserves Could Increase District Borrowing Costs.

Another important reason for districts to maintain solid ending balance reserves is to ensure the ability to secure and maintain the best possible bond rating. Districts borrow funds for a variety of reasons including to finance facility construction/maintenance, cash flow management and other reasons. With state bond funding almost exhausted, districts will be increasingly self-reliant in meeting their facility needs. Therefore, districts may need to seek larger school bonds. Maintaining the best possible bond rating is a critical step to making the most of public investments in local school bonds. Thus, a district's bond rating is critical to ensuring the best use of public funds supporting schools construction.

Just like a home mortgage, small changes in borrowing interest rates can have a significant impact on the overall borrowing costs of a facility project. When districts are forced to pay higher interest rates to borrow money, everyone loses (students, employees, taxpayers). Ending balance reserves is one of the key metrics that bond rating agencies use when determining a districts bond rating. Reductions in ending balance reserves can only hurt a districts bond rating. And significant reductions in reserves to magnitude that would be required to meet the SB 858 caps could likely have an impact on the bond rating for many school districts.

The impact of could be significant. To illustrate, if a district's municipal rating declined from an AAA rating to an AA rating, the difference between the interest rate paid on a municipal bond could be 0.3% or more. While this doesn't seem like a big change, for a district borrowing $100 million over 30 years to build and refurbish its schools, it would cost the district almost an additional $5 million in interest costs.

No Relationship between Size of State Rainy Day Fund and the Ending Balance Cap

Presumably the policy rational for linking the ending balance cap to the timing of state contribution to the Prop 98 rainy day fund is that if the state has funding in its rainy day fund for schools, then schools do not have to carry large reserves themselves. However, there is no linkage between the size of the Prop 98 reserve at the state level and the amount of reductions in ending balances that districts would have to make at the local level. For example, using the most conservative assumed definitions of the SB 858 language, districts are currently maintaining around $5.4 billion in ending-balance reserves beyond the caps that they would face. So, if the state made a $100,000 contribution to the Prop 98 reserve, it could trigger districts needing to reduce their ending-balances by $5.4 billion statewide, and that $100,000 would not provide districts with any type of fiscal safety net. But state officials have said contributions would be few and far between. So if one small contribution to the state Prop 98 rainy day fund triggers a raid on local reserves, the state would be covering the loss of more than $5 billion in local financial security with a mere $100,000 at the state level. Even scarier, using the broader definitions of what can be included in the definitions of assigned and unassigned ending balances, school districts could be losing nearly $17 billion in local balances for mere pennies of security at the state level.

Districts Might Have Only a One Month Warning for Contributions.

In addition, the timing of these decisions could be quite problematic. The ending balance cap triggers on when the State makes a contribution to the Prop 98 rainy day fund, and then a district must adopt a budget in the next fiscal year within the ending balance cap. While it seems like districts would have planning time, in many instances that might not be the case.

For example, each year the Department of Finance revises its current budget year revenue estimates in the May Revision (directly following April tax returns, the largest General Fund revenue month). It is not until these numbers are released that districts know what the next budget will look like. And, in many years, especially in years with large capital gain revenues, the changes in the estimate of current-year revenues can be significant — billions of dollars. These often unexpected increases have been referred to as "May surprises." If the State gets a May surprise that is driven by capital gains revenues (the most volatile part of the State's revenues), it could easily meet the SB 858 trigger, and require that the next budget that a district adopts not contain ending balances in excess of the cap. Under such a scenario, the districts would only have one month to lower its ending balances to meet this requirement.

There have been years, when the Department of Finance has made adjustments to fiscal years that have already ended. It is also feasible that such adjustments could trigger a contribution to the rainy day fund, thereby also triggering the ending balance cap. Thus, a cap could apply when the district is already in the middle of a fiscal year. It is unclear how districts or the State would handle such a situation.

Predictable Impacts of Proposed Ending Balance Caps

The ending balance cap has many predictable negative impacts on school districts fiscal health.

More Districts in Fiscal Distress. FCMAT has identified ending balances as a key predictor of a district's fiscal health. Forcing districts to reduce their ending balances puts more fiscal stress on those districts. For these districts, the cap will likely exacerbate the risk of ending up on one of the State's watch lists (negative or qualified) and potentially going bankrupt and requiring a state bailout. Adequate ending balances can mitigate many other factors, but since this new policy ignores all of those other factors, it simply puts many districts in a more vulnerable fiscal position. As an example of this, Tables 8 and 9 look at the districts that are already identified as being in fiscal distress — negative and qualified districts. Even most of these districts have ending balances that would need to be further reduced.

Districts Would Need to Increase Borrowing. As discussed above, many districts maintain large ending balances to help meet the districts cash flow needs over the course of the year. If districts are not able to maintain adequate reserves to meet their cash flow needs, they will need to borrow more funding to meet those needs. This will result in increased interest expenses. So, an unintended consequence of this proposed policy is that a greater share of district expenditures will be directed to paying interest expenses instead of serving students.

Smaller Reserves Could Impact Credit Ratings and Interest Rates for Borrowing. Because ending balances are one of the key predictors on fiscal solvency, it is one of the main factors that school bond rating agencies consider when assessing the risk of a district's solvency. Obviously the larger the ending balances the less risk there is to a rating agency that the district might default, and thus a lower the interest rate that will be charged for the loan. So, districts may face a double hit from maintaining lower reserves. First, they need to borrow more funds to meet their cash flow needs, while at the same time they have to pay higher interest rates for the funds that they borrow because they have a lower bond rating. For those districts that rely on local school bonds to build and maintain their facilities, the potential impact on the district's credit rating can have multiple years of negative impact.

Districts Will Have Greater Staffing Volatility. Because districts face constraints on their ending balances, a district will likely hire more staff during economic expansions and lay off more staff during economic contractions. For most districts, staffing costs are around 85 percent of expenditures or more. When the economy faces a downturn, districts will not have the fiscal reserves to maintain their existing staffing level, and will thus need to lay off more staff during the downturns.

Most Vulnerable Students Will Suffer the Most from Staffing Volatility. Staff layoffs often impact students negatively, but because of our state's teacher policies, the impact of those layoffs can disproportionately fall on the students with the greatest needs. From past experience and because of existing teacher seniority laws, districts are required to lay off the least experienced teachers. Research has shown that on average at-risk students are more likely to be served by inexperienced teachers than other students. Senior teachers tend to migrate away from struggling schools relocating elsewhere in the district. This leaves vacancies filled by the least experience teachers. Because the least experienced teachers are the first to lose their jobs when a district lays off staff, volatility in staffing tends negatively impacts the most at-risk. Many of the equity groups in the state opposed the related provisions of SB 858 because of this likely consequence of the ending balance cap.

Higher Volume of Pink Slips Can Be Detrimental to District Morale. With lower reserve levels, districts will need to be more responsive to any change in the State's fiscal environment. Thus, in March when the district needs to make its staffing decisions, the district will need to be more conservative in its staffing. During economic downturns, districts will end up issuing a greater number pink slip notices in March. Even if district is able to restore most of those positions by the fall of the following year, the increase volume of notices can have a negative impact on staff moral as teachers and staff worry about whether their jobs are at risk or not.

End of Year Spending Sprees May Not Be Most Efficient Use of Funds. Another predictable impact of ending balance caps, is the potential for districts to make large expenditures at the end of a fiscal year in order to reduce their ending balances. Thus, schools upgrade computers, purchase materials, and other one-time costs. While these expenditures may have benefit to the school in the coming year, they might not be the most effective use of those funds because districts are reacting to the urgency to expend the funds quickly and not focused the best long-term use of the funds. For example, in these spending sprees, increasing staffing levels, investing in professional development, or other investments in faculty quality are not likely options during these spending sprees.

Conclusion

Most of this paper has focused on the impact of the ending balance cap. But this part of SB 858, and the CSBA-supported transparency part of the bill both appear to make a strong suggestion that the minimum required reserve for economic uncertainty is adequate or sufficient. But this paper has demonstrated that there are numerous reasons that districts maintain ending balance reserves. The claim that X percent in ending balances is too high at the state level completely ignores the diversity between every one of the individual school districts in this state and the work that governing boards, their staffs and their communities do not only to keep the financial side of the operation afloat, but the work they do to plan ahead for employee benefits and programmatic investments in students. By requiring districts to spend down their ending balances upon some unrelated trigger at the state level and to annually provide a "statement of reasons that substantiates the need" for reserves beyond the minimum puts enormous pressure on districts to spend down their reserves right now even if such action is financially risky. Isn't the transparency part of SB 858 enough? In the new world of the LCFF and under the foundational concept of "subsidiarity" where the best decisions are made locally, an annual local discussion about reserves and ending balances will bring light to the thinking and reasoning behind whatever levels exist locally. Then, as the governing board, district staff and community grapple with future hopes and dreams for their students, and consider potential pitfalls, a common understanding of the need, or at least of the decisions that go into setting money aside, can be gained. That is not a conversation, nor is it an outcome, that we can expect to dictate with any kind of accuracy or sufficiency from Sacramento. And guess what? If the school board gets it wrong by aiming too low or too high, there are consequences in place in statute if they need to apply for an emergency apportionment or in the next election cycle.

Attachment 1. Excerpt from SB 858 (Chapter 32, Statutes of 2014)—Ending Balance Requirements

Ending Balance Reporting and Justification

42127. (a) (2) (B) Commencing with budgets adopted for the 2015–16 fiscal year, the governing board of a school district that proposes to adopt a budget, or revise a budget pursuant to subdivision (e), that includes a combined assigned and unassigned ending fund balance in excess of the minimum recommended reserve for economic uncertainties adopted by the state board pursuant to subdivision (a) of Section 33128, shall, at the public hearing held pursuant to paragraph (1), provide all of the following for public review and discussion:

i. The minimum recommended reserve for economic uncertainties for each fiscal year identified in the budget.

ii. The combined assigned and unassigned ending fund balances that are in excess of the minimum recommended reserve for economic uncertainties for each fiscal year identified in the budget.

iii. A statement of reasons that substantiates the need for an assigned and unassigned ending fund balance that is in excess of the minimum recommended reserve for economic uncertainties for each fiscal year that the school district identifies an assigned and unassigned ending fund balance that is in excess of the minimum recommended reserve for economic uncertainties, as identified pursuant to clause (ii).

Required Cap on Ending Balances if Rainy Day Fund (Proposition 2) Passes

42127.01. (a) In a fiscal year immediately after a fiscal year in which a transfer is made into the Public School System Stabilization Account, a school district budget that is adopted or revised pursuant to Section 42127 shall not contain a combined assigned or unassigned ending fund balance that is in excess of the following:

1. For school districts with fewer than 400,000 units of average daily attendance, the sum of the school district's applicable minimum recommended reserve for economic uncertainties adopted by the state board pursuant to subdivision (a) of Section 33128, multiplied by two.

2. For school districts with more than 400,000 units of average daily attendance, the sum of the school district's applicable minimum recommended reserve for economic uncertainties adopted by the state board pursuant to subdivision (a) of Section 33128, multiplied by three.

b. A county superintendent of schools may grant a school district under its jurisdiction an exemption from the requirements of subdivision (a) for up to two consecutive fiscal years within a three-year period if the school district provides documentation indicating that extraordinary fiscal circumstances, including, but not limited to, multiyear infrastructure or technology projects, substantiate the need for a combined assigned or unassigned ending fund balance that is in excess of the minimum recommended reserve for economic uncertainties. As a condition of receiving an exception, a school district shall do all of the following:

1. Provide a statement that substantiates the need for an assigned and unassigned ending fund balance that is in excess of the minimum recommended reserve for economic uncertainties.

2. Identify the funding amounts in the budget adopted by the school district that are associated with the extraordinary fiscal circumstances.

3. Provide documentation that no other fiscal resources are available to fund the extraordinary fiscal circumstances.

c. This section shall become operative on December 15, 2014, only if Assembly Constitutional Amendment No. 1 of the 2013–14 Second Extraordinary Session is approved by the voters at the November 4, 2014, statewide general election. If Assembly Constitutional Amendment No. 1 of the 2013–14 Second Extraordinary Session is not approved by the voters at the November 4, 2014, statewide general election, this section shall not become operative and is repealed on January 1, 2015.

Attachment 2. National Accounting Board Requires Greater Transparency in Reporting of Ending Fund Balances

Statute does not define what an assigned and unassigned ending fund balance are. Presumably at some point in the future, the State Board of Education will define these terms either through regulation or through the adoption of a future California School Accounting Manual. For purposes of this analysis, we assume that these terms are consistent with the current standards of the General Accounting Standards Board (GASB). The GASB provides standards for how government entities report accounting information.

In an effort to improve the transparency of government reporting on ending fund balances, GASB recently changed reporting practices. Specifically in 2009, GASB Statement 54 was issued on *Fund Balance Reporting and Governmental Fund Type Definitions* to "enhance the usefulness of fund balance information by providing clearer fund balance classifications that can be more consistently applied and by clarifying the existing governmental fund type definitions…. The requirements in this Statement will improve financial reporting by providing fund balance categories and classifications that will be more easily understood. " So, because of this new requirement, school districts are providing information on ending balances with greater clarity than ever before.

Part of the GASB 54 clarification is the classification of ending balances into five categories based on the level of constraints placed upon the funds including in order of constraints – nonspendable, restricted, committed, assigned and unassigned. While the Education Code does not define what "assigned" and "unassigned" fund balances are, we assume for purposes of this analysis that the use of these categories of ending balances is referring to the GASB 54 definition.

California has specifically identified defined how districts will report assigned and unassigned ending balances through the state's accounting system (SACS) to implement the requirements of GASB 54. For more details on California's implementation of GASB 54 see CDE Correspondence "New Requirements for Reporting Fund Balance in Governmental Funds" (January 7, 2011).

Districts report ending balances for each of their funds. Since the requirements of SB 858 do not specify, it will again be left to the State Board of Education to determine to which fund balances the new requirements apply. For purposes of this analysis, we assume a narrow interpretation including – Fund 01 (General Fund) and Fund 17 (Special Reserve Fund for Other Than Capital Outlay Project). If other fund balances were included, then the impact of the required substantiation of ending balances and potential cap on ending balances would be even more restrictive than what is presented in this analysis.

From New Requirements for Reporting Fund Balance in Government Funds, Attachment B, Assigned and Unassigned Fund Balances are defined as follows:

9770–9788 Assigned Fund Balance.

The portion of fund balance representing resources that are intended to be used for specific purposes but for which the constraints do not meet the criteria to be reported as restricted or committed. Intent may be established either by the LEA's highest level of decision-making authority or by a designated body or official. Constraints giving rise to assigned fund balance may be imposed at any time before the financial statements are issued, and may be modified or removed by a process less formal than is required for committed fund balance. In governmental fund types other than the general fund, this is the residual fund balance classification.

- **9780 Other Assignments.** The portion of fund balance representing assignments.

9789–9790 Unassigned Fund Balance.

The portion of fund balance not classified as nonspendable, restricted, committed, or assigned.

- **9789 Reserve for Economic Uncertainties.** The portion of unassigned fund balance set aside pursuant to a minimum fund balance policy. This amount includes the reserve recommended by the Criteria and Standards for fiscal solvency, as well as additional reserve amounts established pursuant to local policy. Object 9789 is available in Fund 01 and Fund 17.

- **9790 Unassigned/Unappropriated.** In the general fund, residual fund balance in excess of amounts reported in the nonspendable, restricted, committed, or assigned fund balance classifications and net of Object 9789, Reserve for Economic Uncertainties.

  In all governmental funds including the general fund, the excess of nonspendable, restricted, and committed fund balance over total fund balance (deficits). Assigned amounts must be reduced or eliminated if a deficit exists.

Criteria & Standards-School Districts

Criteria and Standards for reviewing school district 2014-15 budgets.

Criteria Information: Budgets

Deviations from the standards must be explained and may affect the approval of the budget.

Criterion	Standard
1. Average Daily Attendance	Funded average daily attendance (ADA) has not been overestimated in the first prior fiscal year or in two or more of the previous three fiscal years by more than the following percentage levels: • 3.0% for districts with 0 to 300 ADA • 2.0% for districts with 301 to 1,000 ADA • 1.0% for districts with 1,001 and over ADA
2. Enrollment	Projected enrollment has not been overestimated in the first prior fiscal year or in two or more of the previous three fiscal years by more than the following percentage levels: • 3.0% for districts with 0 to 300 ADA • 2.0% for districts with 301 to 1,000 ADA • 1.0% for districts with 1,001 and over ADA
3. ADA to Enrollment	Projected second period ADA to enrollment ratio for any of the budget year or two subsequent fiscal years has not increased from the historical average ratio from the three prior fiscal years by more than one half of one percent.
4. Local Control Funding Formula (LCFF) Revenue	Projected LCFF revenue for any of the budget year or two subsequent fiscal years has not changed from the prior fiscal year by more than the change in population, plus the district's gap funding or cost-of-living adjustment (COLA)1 and its economic recovery target payment, plus or minus one percent. For basic aid districts, projected LCFF revenue has not changed from the prior fiscal year by more than the percent change in property tax revenues plus or minus one percent. For districts funded by necessary small school formulas, projected LCFF revenue has not changed from the prior fiscal year amount by more than the district's gap funding or COLA1 and its economic recovery target payment, plus or minus one percent.
5. Salaries and Benefits	Projected ratio of total unrestricted salaries and benefits to total unrestricted general fund expenditures for any of the budget year or two subsequent fiscal years has not changed from the historical average ratio from the three prior fiscal years by more than the greater of three percent or the district's required reserves percentage. It is likely that for many districts the 2014–15 and 2015–16 change from the historical average ratio will exceed the standard because certain revenues that were restricted prior to the LCFF are now unrestricted within the LCFF.

Criterion	Standard
6. Other Revenues and Expenditures	Projected operating revenues (including federal, other state and other local) or expenditures (including books and supplies, and services and other operating), for any of the budget year or two subsequent fiscal years, have not changed from the prior fiscal year amount by more than the percentage change in population and the funded COLA plus or minus ten percent. For each major object category, changes that exceed the percentage change in population and the funded COLA plus or minus five percent must be explained.
7. Facilities Maintenance	Confirm that the annual contribution for facilities maintenance funding is not less than the amount required pursuant to Education Code Section 17070.75, if applicable, and that the district is providing adequately to preserve the functionality of its facilities for their normal life in accordance with Education Code sections 52060(d)(1) and 17002(d)(1).
8. Deficit Spending	Unrestricted deficit spending (total unrestricted expenditures and other financing uses is greater than total unrestricted revenues and other financing sources) as a percentage of total unrestricted expenditures and other financing uses, has not exceeded one-third of the district's available reserves2 as a percentage of total expenditures and other financing uses3 in two out of three prior fiscal years.
9. Fund Balance	Budgeted beginning unrestricted general fund balance has not been overestimated for two out of three prior fiscal years by more than the following percentage levels4: • 1.7% for districts with 0 to 300 ADA • 1.3% for districts with 301 to 1,000 ADA • 1.0% for districts with 1,001 to 30,000 ADA • 0.7% for districts with 30,001 to 400,000 ADA • 0.3% for districts with 400,001 and over ADA
10. Reserves	Available reserves2 for any of the budget year or two subsequent fiscal years are not less than the following percentages or amounts as applied to total expenditures and other financing uses3: • the greater of 5% or $64,000 for districts with 0 to 300 ADA • the greater of 4% or $64,000 for districts with 301 to 1,000 ADA • 3% for districts with 1,001 to 30,000 ADA • 2% for districts with 30,001 to 400,000 ADA • 1% for districts with 400,001 and over ADA

1 Districts that are already at or above their LCFF target funding level as described in Education Code Section 42238.03(d) receive no gap funding. These districts have a COLA applied to their LCFF target, but their year-over-year revenue increase might be less than the statutory COLA due to certain local factors and components of the funding formula.

2 Available reserves are the unrestricted amounts in the Reserve for Economic Uncertainties and the Unassigned/Unappropriated accounts in the General Fund and Special Reserve Fund for Other Than Capital Outlay Projects. Available reserves will be reduced by any negative ending balances in restricted resources in the General Fund.

3 A school district that is the Administrative Unit of a Special Education Local Plan Area may exclude from its expenditures the distribution of funds to its participating members.

4 Percentage levels equate to a rate of deficit spending which would eliminate recommended reserves for economic uncertainties over a three year period.

Supplemental Information: Budgets

Provide methodology and assumptions used to estimate ADA, enrollment, revenues, expenditures, reserves and fund balance, and multiyear commitments (including cost-of-living adjustments).

Provide information on additional indicators as requested.

Supplemental Information	Provide supplemental information as follows:
S1. Contingent Liabilities	Identify any known or contingent liabilities from financial or program audits, state compliance reviews, litigation, etc., that may impact the budget.
S2. Use of One-Time Revenues for Ongoing Expenditures	Identify any ongoing general fund expenditures in excess of one percent of the total general fund expenditures that are funded with one-time resources in the budget year, and explain how the one-time resources will be replaced to continue funding the ongoing expenditures in the following fiscal years.
S3. Use of Ongoing Revenues for One-time Expenditures	Identify any large non-recurring general fund expenditures that are funded with ongoing general fund revenues.
S4. Contingent Revenues	Identify projected revenues for the budget year and two subsequent fiscal years that are contingent on reauthorization by the local government, special legislation, or other definitive act (e.g. parcel taxes). If any of these revenues are dedicated for ongoing expenses, explain how the revenues will be replaced or the expenditures reduced.
S5. Contributions	Identify projected contributions from unrestricted resources in the general fund to restricted resources in the general fund for the budget year and two subsequent fiscal years. Provide an explanation if contributions have changed from the prior fiscal year amounts by more than $20,000 and more than ten percent. Explanation should include whether contributions are ongoing or one-time in nature. Identify projected transfers to or from the general fund to cover operating deficits in either the general fund or any other fund for the budget year and two subsequent fiscal years. Provide an explanation if transfers have changed from the prior fiscal year amounts by more than $20,000 and more than ten percent. Explanation should include whether transfers are ongoing or one-time in nature. Estimate the impact of any capital projects on the general fund operational budget.

Supplemental Information	Provide supplemental information as follows:
S6. Long-term Commitments	Identify all existing and new multiyear commitments1 and their annual required payment for the budget year and two subsequent fiscal years. Explain how any increase in annual payments will be funded. Also explain how any decrease to funding sources used to pay long-term commitments will be replaced.
S7. Unfunded Liabilities	Estimate the unfunded liability for post employment benefits other than pensions (OPEB) based on an actuarial valuation, if required, or other method; identify or estimate the annual required contribution; and indicate how the obligation is funded (pay-as-you-go, amortized over a specific period, etc.). Estimate the unfunded liability for self-insurance programs such as workers' compensation based on an actuarial valuation, if required, or other method; identify or estimate the required contribution; and indicate how the obligation is funded (level of risk retained, funding approach, etc.).
S8. Status of Labor Agreements	Analyze the status of employee labor agreements. Identify new labor agreements, as well as new commitments provided as part of previously ratified multiyear agreements; and include all contracts, including all administrator contracts (and including all compensation). For new agreements, indicate the date of the required board meeting. Compare the increase in new commitments to the projected increase in ongoing revenues and explain how these commitments will be funded in future fiscal years. If salary and benefit negotiations are not finalized at budget adoption, upon settlement with certificated or classified staff: • The school district must determine the cost of the settlement, including salaries, benefits, and any other agreements that change costs, and provide the county office of education with an analysis of the cost of the settlement and its impact on the operating budget. • The county superintendent shall review the analysis relative to the criteria and standards and may provide written comments to the president of the district governing board and superintendent.
S9. Local Control and Accountability Plan (LCAP)	Confirm that the school district's governing board has adopted an LCAP or an update to the LCAP effective for the budget year.
S10. LCAP Expenditures	Confirm that the budget includes the expenditures necessary to implement the LCAP or annual update to the LCAP.

1 1 Include multiyear commitments, multiyear debt agreements, and new programs or contracts that result in long-term obligations.

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